More about Convertible Preferred Stock

A startup company ("venture" in Korea) requires what seems like endless pools of capital to fund its operations as well as its research and development. Usually, this means that the venture will have to turn to professional investors, who can provide not only the money necessary to fund operations and R&D, but also strategic and often tactical advice on how to run the company. Venture capitalists fill this role, and they typically require that the venture package its investment in the form of convertible preferred stock.

Many entrepreneurs (and frankly, Korean investors) are confused and daunted by this instrument, which yields significant control of the company to the VC. From the VC's point of view, however, the basic structure of most investments in entrepreneurial companies is similar, driven largely by the key objectives of the VC fund and its managers.

In venture capital, as elsewhere, the "golden rule" generally applies:

"He who has the Gold makes the Rules",

and the venture capitalist's goals will influence the structure of its investment, which are outlined below, in a format that will familiarize the reader with the typical deal documents for a US VC transaction.

The basic terms and conditions of the structure will be set forth in a term sheet (the "Term Sheet") prepared by the VC and given to the entrepreneur and the company as a part of a letter of intent (the "LOI"). The LOI and Term Sheet generally are not intended to be binding on the parties, with the exception of certain provisions (for the payment of expenses, whether or not the transaction closes, or exclusive dealing rights, which may be included as legally binding agreements). The Term Sheet is negotiated since it sets forth the basic terms of the investment structure as well as the financial terms upon which the investment is proposed to be made.

VCs often use outside counsel to prepare the Term Sheet and LOI. Some do not, and such VCs will deliver the Term Sheet directly to the entrepreneur with the expectation that will be discussed and negotiated largely between the business people, without the active participation of the lawyers on either side. However, because the Term Sheet becomes the "road map" for the preparation of the definitive documentation, and since the Term Sheet is only a summary of the principal terms of the investment, the entrepreneur should consult with experienced counsel and other financial advisors when the Term Sheet is being negotiated. These advisors can give the entrepreneur a full explanation of the ramifications of the summary provisions of the Term Sheet and can suggest negotiating positions that can move the parties toward an agreement. Often, this process can minimize the likelihood of unpleasant surprises arising out of the negotiation of the full-blown investment documentation. More importantly, the lawyer for the entrepreneur's company (the "sell side") can advise his client on risk management vis-à-vis potential future events. This is a fundamental difference between Korean attorneys and good US attorneys, who strive to be more than mere draftsmen or scribes.

Once the Term Sheet has been negotiated and the LOI has been executed by the parties, counsel for the VC will prepare and circulate drafts of the principal investment documents, based upon the provisions agreed to in the Term Sheet (the "road map"), but set forth in more complete detail, and including other "standard" provisions. This set of documents, including not only agreements among or between the companies, some or all of its existing stockholders and, where relevant, its employees, as well as the VCs, also include provisions to be included in the company's charter and bylaws. A typical set of investment documents is described below.

Much of this material may be found at www.vcexperts.com, a great (subscription priced) website for materials on US venture capital transactions, which I highly recommend and hereby give due credit for some of the materials for the Global Sense column.

The "contract" and legal rights of the parties governing their future relations are set forth in the investment documentation agreed to by the parties at the time the investment is made. This does not mean that these terms aren't subject to change, but such changes will be made (amendments and modifications) according to the terms of the contract. This is also different from typical Korean transactions, where it is often assumed that the contracts are binding, but flexible. The US regime retains flexibility, but only according to the terms of the agreements themselves. The contract means what it says. For example, a closing is a closing, not a promise to deliver money at some future date when it's convenient, with an option to renege…

While the terms of conditions of a particular transaction can be customized ("tweaked"), the VC industry has developed a standard set of documentation that the entrepreneur should expect to see. These standard documents come from a consensus set derived over years of practice by Silicon Valley law firms such as Wilson Sonsini Goodrich & Rosati, as well as others.

Since the documentation is prepared by the VC, it is designed largely to protect the rights of the investors. While the terms are negotiable, negotiating positions that vary materially (substantially) from the principal terms set forth in the Term Sheet will typically not be accepted, absent unusual circumstances, and may result in a breakdown of the investment process. Therefore, the entrepreneur should address the principal terms when the LOI is executed, even though it may not be legally binding.

Why? It facilitates the deal process, and makes it easier to derive an acceptable solution for all parties. We don't optimize, but satisfice, based on the differing goals and relative power of the parties. Good lawyering is essential to this process, particularly if the parties haven't dealt with this type of instrument before.

The "standard" set of investment documents includes the following: **Securities Purchase Agreement** (also called a Preferred Stock Purchase Agreement or Note and Warrant Purchase Agreement, or similar designation, depending upon the structure of the investment), **Form of Investment Security** (including typically the Preferred Stock terms, or the forms of Note and Warrant), **Registration** Rights Agreement, **Exit Rights Agreement** (or alternatively a "Put" Agreement, if such terms are not included in the Stockholders Agreement), **Stockholders Agreement**, **Employee Agreement** (and Restricted Stock Agreement or similar designation), **Non-Compete Agreement** and an **Inventions and Confidentiality Agreement**

This set of documentation, taken together, governs the legal rights of the parties relating to the investment and the legal aspects of the company's operations after the investment. Remember that these work as a set, and not independently.

The principal terms of these documents are described below.

The Securities Purchase Agreement (or Preferred Stock Purchase Agreement or Note and Warrant Purchase Agreement or similar designation) typically contains the following principal terms:

1. The commitment of the investors to purchase the newly issued securities of the company, which may be common stock, preferred stock, promissory notes (including convertible notes) and stock purchase warrants, or some combination of these securities, which may be purchased in whole at the initial closing, or which may be purchased over time, depending upon the achievement of certain milestones;
2. The representations and warranties of the company as to the material facts relating to its organization and business, requiring relatively complete disclosure of any material arrangements;
3. The representations and warranties of investors as purchasers of the company's securities;
4. Affirmative and negative covenants of the company (the breach of which may give rise to contractual claims for damages, or which may result in other consequences, such as changes

in the composition of the Board of Directors, or a default on outstanding indebtedness, or the like), including limitations on debt, mergers and acquisitions, changing the business focus, transactions with affiliates and changes in compensation for the key managers, as well as provision for certain information rights (financial statements, board participation, inspection rights, etc.);

5. Conditions to the obligations of the VC investors to fund the investment (which will typically include the execution and delivery of the other agreements included in the standard investment documentation);
6. Special provisions (covering any special arrangements between the parties); and
7. Miscellaneous provisions (often called "legal boiler-plate").

Please note that the representations and warranties, on both sides, are there to push due diligence as well as provide triggers for an “out” in the event of breach.

The investment security will be either an equity security (such as common stock or preferred stock in the case of corporate issuers), or some sort of debt instrument (such as promissory notes or debentures, which may be convertible into an equity security), or rights to acquire an equity security (such as stock purchase warrants which may cover either preferred or common stock).

While we don’t have enough space in this column to detail out each term, I’d like to provide a “laundry list” here so that the reader will have a minimum familiarity with what to expect and where to expect it.

The terms of the security will be contained in the corporate charter or articles of incorporation, which legally define the entity itself under state law, for common or preferred stock and in the terms of the instrument itself for promissory notes, debentures or warrants. The terms of equity securities typically cover voting rights, dividends (including preferential and cumulative dividends), liquidation preferences, conversion or exchange rights, redemption or "put" rights (usually in favor of the investors), and special provisions relating to the Board of Directors, including rights to assume control. This is what I’ve referred to as the “hard wiring” of the terms of the instrument in other columns.

The terms of debt instruments will include provisions for the payment of interest and principal, default provisions, provision for collateral or guarantees (which will be more completely set forth in separate documents) and, if applicable, conversion or exchange rights.

Special affirmative or negative covenants may also be included in the terms of the equity or debt securities as well as in the Securities Purchase Agreement or Stockholders Agreement.

Convertible securities (e.g., convertible preferred stock or convertible or exchangeable notes) or warrants will also typically contain "anti-dilution" protection, usually giving the investors the right to obtain more common stock, without additional aggregate consideration, in the event the company subsequently issues new common stock (or common stock equivalents) at a price below the effective "as converted" common stock price paid by the investors. The anti-dilution provisions can be quite complex and typically will be based on either the so-called "full ratchet" or "weighted average" formula. Essentially, this protection is necessary so that the investor’s stake in the company is protected.

The Registration Rights Agreement sets forth the rights of the investors to US Securities and Exchange Commission (the “SEC”) registration of their equity securities, which will typically include "demand" registration rights and "piggyback" registration rights, as well as related agreements governing the procedures and understandings of the parties as to the implementation of such rights (the "cutback" provisions and indemnity agreements).

Why? These rights are necessary to facilitate public sale of the securities, which of course is the goal of the investors.

The Stockholders Agreement, which will be entered into among the company, the investors and the principal management stockholders of the company, will often contain provisions that are peculiar to each investment transaction or company, but will typically include restrictions on transfer (such as no transfers for a period of time or without the approval of the Board of Directors), rights of first refusal on proposed transfers, voting agreements with respect to the Board of Directors or other matters, and "co-sale" rights (sometimes referred to as "tag-along" or "drag-along" rights). The co-sale rights set forth the rights of the investors and/or others to participate in certain sales of stock by the entrepreneur or other key management stockholders (the "tag-along" right) and the right of the investors to require the management to participate in a sale of stock by the investors (the "drag-along" right). The Stockholders Agreement (or in some cases, the Restricted Stock Agreement with each key stockholder employee) may also include provision for the purchase of the stock held by the entrepreneur or other key management personnel in the event of death or termination of employment (including a "call" in favor of the company, or a "put" in favor of the stockholder or his or her estate, or both), with provision for differing valuations applicable to the purchase, depending upon the circumstances.

Why is there such a complicated set of rights set forth in this set of agreements? All of these provisions work together to protect the financial investor’s stake in the company by aligning the interests of the other parties in the ecology of the company.

The Exit Rights Agreement, if there is one, typically replaces the Registration Rights Agreement and may replace the Stockholders Agreement. This document is not typical, and the usual situation is that the other two documents will contain the operative provisions of this one. It will contain the registration rights of the investors as well as any redemption or "put" rights as to common stock or war-rants and any "co-sale" rights, all of which provide opportunities for the investors to obtain liquidity for, or "exit", the investment.

In addition, the investors will want the employment arrangement of the entrepreneur and other key management personnel to be set forth in written agreements, which will provide for duties and responsibilities, compensation (including participation in bonus or other profit sharing or incentive compensation plans or stock option arrangements) and the rights of the company to terminate the employment arrangements, including severance benefits that may be available. The VCs will require that some or all of the common stock or options held by the key management team, or issued to them pursuant to equity incentive plans, be subject to Restricted Stock Agreements, providing for a "vesting" of the rights to the stock or options over a period of three to five years, usually four, with restrictions on transfer and "call" or buy-back rights in favor of the company at death or other termination of employment at a price depending on the circumstances of such termination.

Why? The VC must tie the entrepreneur down with the “upside” incentive, particularly in an environment where non-competes are not entirely effective.

The investors will typically want the key employees, including the entrepreneur, to enter into non-compete agreements in the event of termination of employment (including termination after the investors have assumed control), the term of which may be related to the severance benefits available. As mentioned previously, these agreements may not be entirely enforceable, particularly in California, including Silicon Valley. Some analysts have attributed part of the success of the Valley to this non-enforceability.

The investors should require the key employees to enter into inventions and confidentiality agreements confirming the rights of the company to any intellectual property developed by the key employees, as well as setting forth the obligation of the key employees to maintain confidentiality as to the company's proprietary information and trade secrets.

Why? The VC must tie down the other asset of the company (the first being the people), which in a venture, is often the IP. There's usually nothing else.

In summary, four key considerations motivate a VC's investment structure:
_ Maximizing financial returns;
_ Priority protection against loss;
_ Participation in management and potential control; and
_ "Exit" rights.

These objectives seem simple, but it's not easy to achieve all four goals. Compromises and complex solutions must be derived. For example, although a common stock investment will often be a good form for maximizing potential financial returns, common stock will not provide the VC with priority protection against loss or potential control of management, and may provide only limited "exit" (or rights to obtain liquidity) opportunities.

We will go into further detail on these four considerations in future articles.